

loan pursuant to this section, such production payment shall be apportioned between the transferred portion and the retained portion by allocating to such transferred portion that part of the outstanding principal balance of the production payment which bears the same ratio to such balance as the value of such transferred portion (exclusive of any value not related to the burdened mineral) bears to the total value of the burdened mineral property (exclusive of any value not related to the burdened mineral).

(4) In general, the entire amount of gain or loss realized pursuant to this paragraph shall be recognized in the taxable year of such realization. See section 1211 for limitation on capital losses. This subparagraph shall not affect the applicability of rules providing exceptions to the recognition of gain or loss which has been realized (e.g., a transfer to which section 351 or 1031 applies). However, see section 357(c) with respect to the assumption of liabilities in excess of basis in certain tax-free exchanges. Furthermore, in the case of a transaction which otherwise qualifies, gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453.

[T.D. 7261, 38 FR 5463, Mar. 1, 1973]

#### § 1.636-2 Production payments retained in leasing transactions.

(a) *Treatment by lessee.* In the case of a production payment (as defined in paragraph (a) of § 1.636-3) which is retained by the lessor in a leasing transaction (including a sublease or the exercise of an option to acquire a lease or sublease), the lessee (or his successors in interest) shall treat the retained production payment for purposes of subtitle A of the Code as if it were a bonus granted by the lessee to the lessor payable in installments. Accordingly, the lessee shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income for the taxable year so applied. The lessee shall capitalize each payment (including any interest and any amounts added on to the production payment other than amounts for which the les-

see would be liable in the absence of the production payment) paid or incurred with respect to such production payment. See paragraph (c)(5)(ii) of § 1.613-2 for rules relating to computation of percentage depletion with respect to a mineral property burdened by a production payment treated as a bonus under section 636(c) and this section.

(b) *Treatment by lessor.* The lessor who retains a production payment in a leasing transaction (or his successors in interest) shall treat the production payment without regard to the provisions of section 636 and § 1.636-1. Thus, the production payment will be treated as an economic interest in the mineral in place in the hands of the lessor (or his successors in interest) and the receipts in discharge of the production payment will constitute ordinary income subject to depletion.

(c) *Example.* The provisions of this section may be illustrated by the following example:

*Example.* In 1971, A leases a mineral property to B reserving a one-eighth royalty and a production payment (as defined in § 1.636-3(a)) with a principal amount of \$300,000 plus an amount equivalent to interest. In 1972, B pays to A \$60,000 with respect to the principal amount of the production payment plus \$16,350 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1972 and subsequent years will include (subject to proper adjustment under section 1016) the \$76,350 paid to A. In 1973, B pays to A \$60,000 with respect to the principal amount of the production payment plus \$12,750 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1973 and subsequent years will include (subject to proper adjustment under section 1016) the \$72,750 paid to A. The \$76,350 received by A in 1972, and the \$72,750 received by A in 1973, will constitute ordinary income subject to depletion in the hands of A in the years of receipt of such amounts by A.

[T.D. 7261, 38 FR 5465, Mar. 1, 1973]

#### § 1.636-3 Definitions.

For purposes of section 636 and the regulations thereunder:

(a) *Production payment.* (1) The term *production payment* means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from